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Trade

The Canadian-U.S. Experience in Auto Trade since 1965: *Its Relevance for Free Trade Negotiations with Mexico*

by

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Under the 1965 auto pact, the United States allowed duty-free entry of cars produced in Canada provided they contained 50 percent Canadian or U.S. content. This U.S. action protected both the United States *and* Canada from third-country competition. Canadian safeguards, however, protected production in Canada but not in the United States — a continuing source of U.S. concern.

Under the 1989 Canada-U.S. Free Trade Agreement (FTA), the United States got Canada to end or phase out the duty remissions it had been using to induce Japanese and other East Asian producers to locate in Canada. These remissions were similar in some, but far from all, respects to those provided U.S. companies under the auto pact. Arguably, however, they subsidized Japanese exports to the United States; had they not been ended, they likely would have triggered U.S. countervailing action.

Canada got the United States to leave the auto pact formally intact; tacitly, then, the United States conceded the permanence of the Canadian safeguards. One incentive for firms to meet these safeguards was removed, however, because the FTA phased out the Canadian tariff at the U.S. border, and relief from this tariff was the incentive for firms to produce at safeguard levels. Nonetheless, another important incentive still exists — the several hundred millions of dollars of savings firms get from remission of the Canadian tariff that still does remain on imports from third countries.

Two of the important implications of this experience for any free trade agreement with Mexico are, first, the United States cannot be expected to accept Canadian-type safeguards for Mexican auto production. Second, it is important that Canada participate in any Mexico-U.S. free trade negotiation — whether it be in autos or more broadly across all sectors — to ensure that the strong competitive position in the U.S. market that Canada established in the 1965 auto pact and the 1989 FTA are not eroded.

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This *Commentary* summarizes Canadian and U.S. experience in auto trade since the 1965 Canada-U.S. Automotive Products Agreement (commonly referred to as the "auto pact") — perhaps the most important sectoral agreement ever negotiated between two countries. How has the auto pact worked out? Why was it inadequately designed to deal with a challenge not predicted in 1965 — the advent, in force, of Japanese automakers? How was it modified in 1989 by the Canada-U.S. Free Trade Agreement? How is this experience relevant if, in negotiating a broader free trade agreement, Canada, Mexico, and the United States write an auto products chapter like Chapter 10 in the Canada- U.S. FTA?

The Auto Industry: Background

The growing importance of world auto trade is illustrated by the huge two-way trade between Canada and the United States. In 1988, 6 percent of Canada's GDP was accounted for by exports of autos and parts to the United States. That was almost equal to Canadian exports of *all goods to all other countries.*

The auto industry, however, faces problems that apply worldwide. One of these is the fact that world sales have not kept up with increased capacity in the industry. In the late 1970s, for example, it was predicted that world sales would grow tc 50 million cars by 1990, and the industry expanded its capacity accordingly. By 1982, that prediction had been reduced to fewer than 38 million, and predictions have fallen even further since then.[1] One important reason for this decline is that the improved quality of automobiles has made them last longer.

A second problem is the changing pattern of trade protection. By the 1980s, there was some evidence of a worldwide move to replace import substitution with export promotion — as Canada has been doing in the auto pact with the United States, and as South Korea has been doing in its use of tax incentives. In one sense, export promotion is a better form of protection, since it allows the industry to become more efficient because it can specialize, exploiting economies of scale in servicing the world rather than a small domestic market. The problem with this policy, however, is that it increases potential conflicts between auto-producing countries, especially in a world of excess capacity where any country's export-promotion policies will be watched with great care by importing countries already suffering from excess capacity. This conflict may be exacerbated in the period of overcapacity in the 1990s by an increase in traditional import-substitution policies.

The 1965 Canada-U.S. Auto Pact

In negotiating the auto pact, Canada and the United States had different objectives.[2] The U.S. objective was to create a large, bilateral free trade market. The Canadian objective was to protect production in Canada while promoting efficiency in this production. Mexico's past record of severe restraints on auto imports — admittedly, now being relaxed — suggests that Mexicans may share the Canadian objective of protecting production. However, this paper will show that there is little prospect that they will be as successful as Canada in this pursuit — if, indeed, they get any protection at all.

Under the auto pact, auto manufacturers received:

(a) duty-free treatment in shipping autos and original equipment parts from Canada into the United States provided they met a requirement of 50 percent *Canadian or U.S.* content — a standard requirement in a bilateral free trade agreement;

(b) duty-free treatment in shipping autos and original equipment parts from any country[3] into Canada provided they met certain production safeguards in Canada; these were guarantees that there would be a specified amount of value added in Canada, and that there would be a certain amount of vehicle assembly here.

It was these Canadian safeguards in provision (b) that made the auto pact unique, since Canada protected production located specifically in Canada — whereas in provision

(a), the United States protected production in either country. Because these provisions were asymmetric, protecting production in Canada but not in the United States, the Canadian safeguards were of continuing concern in the United States and a source of conflict between the two countries. On a number of occasions, the United States raised the question of whether these safeguards had been meant to be temporary or permanent. It is far from clear that the negotiators meant for them to be permanent, but the Canadian government interpreted them in this way and they are, in fact, still there 25 years later.[4]

Note that a third-country firm, such as Volvo, could locate in Canada and still ship duty free into the United States, because in Canada it would be creating North American content. On the other hand, Volvo could not locate just in the United States and ship duty free into Canada because its U.S. production would not satisfy the safeguard requirement of production in Canada. This was not a problem so long as third-country manufacturers were relatively minor players, as was the case with Volvo, but it did become a problem when Japanese automakers arrived in strength. At that point, it became clear that the bilateral auto pact was not designed to handle a situation in which a third country (Japan) had come to play one of the dominant roles.

The Japanese Arrival in Force in North America: Voluntary Export Restraints

When Japanese automakers rapidly began to increase their share of North American sales, the United States and Canada pressed the Japanese to introduce voluntary export restraints (VERs). This forced the Japanese to cartelize their export sales to North America by reducing quantity and raising price in a collusive way that would have put U.S. executives in jail had they tried to do the same. That is, this policy led to an improvement in Japan's terms of trade at the expense of Canada and the United States, the two countries that had introduced this policy. This paradoxical outcome is no surprise when one recognizes that trade policy — in this case by Canada and the United States — tends to reflect producers', rather than consumers', interests. Thus, protection is introduced because it provides benefits to producers, with the even greater cost to consumers being given little weight.

This VER policy had other effects as well. First, the Japanese upgraded their cars. Since the number of cars they could ship into Canada and the United States was restricted, the Japanese shifted their exports toward high-quality, expensive lines, with the result that they are now the only serious contenders to the Europeans in the world luxury market outside North America.

Second, by raising the price of cars in the United States, the VER policy subsidized U.S. auto workers. This led to the question: "Why should the average U.S. worker who buys a car subsidize auto workers who already receive higher wages?" The policy also subsidized management — the most publicized examples were the large awards the Big Three auto firms made to their senior executives — again at the expense of the auto purchaser. This high-profile largesse has been cited as one of the contributing reasons why U.S. policy changed and the U.S. government relaxed the pressure on the Japanese to impose VERs. However, the Japanese still continued to limit exports, even after this action had actually become voluntary. One possible explanation was that the Japanese had learned, in response to North American pressure, how to cartelize their export sales and they had found this to be a very profitable policy. (Their official explanation was that this policy was being continued to prevent a revival of U.S. protectionism.)

The third effect of the VER policy was that, while they won in the short run because of higher-priced auto sales, North American producers may well have lost in the long run because Japanese firms jumped the VER barriers at the U.S. border by locating production within the United States. This left U.S. firms facing even stiffer competition from the Japanese — competition which could not be kept in

check in the future by restrictive trade policies. Ironically, some North American producers had earlier predicted that the Japanese would locate in North America, and they had taken the view that, by so doing, the Japanese would have to compete on even terms with North Americans and would be beaten. It has not been that easy.

Canadian Attempts to Get Japanese Firms to Locate in Canada

Initial Japanese investment in North America was scheduled to take place in the United States. Accordingly, Canada reacted by introducing a duty-remission program to attract them here instead. (It should be understood that, by "Japanese", I also include other East Asian firms — notably from South Korea.) Japanese manufacturers locating in Canada received duty remission on their imports from Japan and elsewhere, provided they produced in Canada (or exported from Canada). This was broadly similar to the duty remission that U.S. companies were receiving under the auto pact, although details differed, sometimes significantly. For example, the Japanese received a less substantial duty remission, but they got it more quickly; moreover, they were not obliged to wait until their Canadian production increased all the way up to levels required by the auto pact. In this way, Canada can be said to have given Japanese companies a sort of "introductory" auto pact treatment, with the idea being that they would eventually increase their production in Canada up to the level that would allow them to qualify for the even more generous duty remission under the auto pact.

As a result of this policy, projected Japanese investment in Canada increased to far more than a proportionate 10 percent of total Japanese investment in North America, meaning that there would likely be a future Canadian trade surplus with the United States in *Japanese* automobiles. This was clearly building up as a source of potential conflict between the two countries, since Japanese cars built in Canada would be sold in the United States under the favorable conditions allowed Canada under the auto pact. The United States was also concerned because the Canadian duty remissions (especially those tied to exports) arguably were export subsidies. Moreover, from a U.S. point of view, these Canadian duty remissions were worse than the ones offered to U.S. firms before 1965 that had led to the trade crisis that triggered the original auto pact negotiations; at that time, most of the duty remissions applied, in practice, to imports *from the United States* and generated employment there, whereas the duty remissions for the Japanese in the 1980s were on imports *from Japan* and generated employment in that country instead.

The result was a potential time bomb:[5] Once the Japanese located in Canada and began exporting south in force, the United States would be damaged and could respond with countervailing measures. How would Canada then remove the countervail by ending a subsidy that had been contractually promised to Japanese firms that, by that time, had invested heavily in Canada? One of the objectives of the FTA negotiations between Canada and the United States was to defuse this time bomb in a graceful way.

The 1989 Canada-U.S. FTA and the Auto Pact

Under the FTA, Canadian duty remissions tied to exports were abolished, and those already existing and tied to production were to be grandfathered and phased out. Although the existing companies that already qualified for auto pact treatment (most notably, the Big Three) could continue to do so, no new firms (most notably, the Japanese) were to be allowed to qualify unless they could do so almost immediately. These two provisions are what the United States got in autos from the FTA negotiations. Both can be viewed as restrictions on the ability of the Canadian government to provide incentives for Japanese firms to produce in Canada — most specifically, for export to the U.S. market. Incidentally, these provisions are about the only grounds on which excluded countries can argue that the

FTA increases protection against outsiders. In particular, it may be argued that the Japanese lost because duty remissions they had been getting from the Canadian government were ended, and their future membership in the auto pact was blocked.

What did Canada get in auto trade from the FTA? The answer is that the auto pact was, at least formally, left intact. This meant that the United States implicitly conceded that the auto pact safeguards for production in Canada could be viewed as permanent. That was not as substantial a concession as it might seem, however, because the FTA will modify those safeguards *indirectly*, and this has triggered a considerable debate in Canada. Opponents of the FTA have argued that it has "gutted" the auto pact because the Canadian tariff on auto imports from the United States is to be phased out, and relief from this tariff has been the incentive to produce at the safeguard levels in Canada. Thus, opponents argue, the FTA has destroyed the effectiveness of the safeguards. There is, however, another incentive for firms to produce at safeguard levels, and it still remains: Even after autos move completely duty free within North America, Canada will still levy duties on products — such as Dodge Colts — that are imported from third countries by the Big Three. The incentive for these firms to produce at safeguard levels in Canada will be the savings of several hundred million dollars per year that these firms get from avoiding duties on these imports. (If all auto tariffs are removed worldwide, this incentive will also disappear, and Canadian safeguards *will* become ineffective; but they will have been eliminated not by the FTA but by world free trade in autos.)

One of the FTA's provisions was that Canada and the United States would set up a select panel to study ways to make their auto industry more competitive, and to consider a possible change in the Canadian-U.S. content requirement. In August 1990, the panel recommended that the content requirement be increased from 50 percent to 60 percent. If this recommendation were to be accepted, it would provide Canadian and U.S. parts producers with more protection from third-country producers. This would have two effects. First, by restricting imports and putting upward pressure on the price of parts, this protection would make Canada and the United States less attractive locations for producing autos. They would, however, become more attractive locations for parts producers, including the Japanese. In the longer run, therefore, this protection may have much the same effect on Japanese parts producers as VER protection had on Japanese auto producers; it will provide an incentive for them to produce more in Canada and the United States. Thus, while this increased protection may provide relief for Canadian and U.S. parts firms temporarily, down the road it may mean that these firms will have to face increased competition from Japanese parts firms, which, from their new

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North American location, may be supplying more not only to Japanese automakers, but also to the Big Three.

In deciding on whether or not this recommendation should be put into effect, the U.S. and Canadian governments should remember that the select panel is heavily weighted with members from the auto and auto parts industry, and that, accordingly, a broader view of the public interest is required. (The claim that the panel is another example of putting the foxes in charge of the henhouse is too strong; for example, it cannot be assumed that the members from the auto industry will vote like those from the parts industry, since their interests are in conflict.)

Now let us turn to the question of how this Canadian-U.S. experience since 1965 may be relevant to possible Mexican participation in North American free trade in autos.

Relevance for Mexico

This experience suggests four messages for Mexico. First, the safeguards provision of the auto pact was a continuing source of disagreement and conflict between Canada and the United States, and was one of the reasons why Canada's other sectoral initiatives during the 1980s got nowhere. The United States is unlikely to want to repeat this by offering similar safeguards for Mexico — although it is not inconceivable that, as part of a broader compromise package, the United States might consider strictly temporary safeguards, with a clearly specified phase-out period.

Second, producers in Mexico already have an attractive trading arrangement with the United States through their preferential access to the U.S. market under the Generalized System of Preferences (GSP). Moreover, under U.S. tariff items 806.30 and 807, autos produced in Mexico can be exported to the United States free of duty on their U.S. content. In addition, Maquiladora producers benefit from low-cost inputs because they are able to acquire imports duty free.

If Mexico were to negotiate complete free trade in automobiles with the United States and Canada, production in Mexico would benefit because autos could be exported to the United States free of duty on their total value — including, in particular, their Mexican content — rather than just on their U.S. content. Moreover, in a tripartite agreement, autos produced in Mexico would get similar duty-free access to Canada. Another incentive for Mexico, in addition to improving its present trading conditions, is to ensure that these conditions will not be damaged by new U.S. protective measures. This is similar to one of the important Canadian incentives in negotiating the 1965 auto pact and the 1989 FTA with the United States.

Third, with the recent reductions in Mexican tariffs — and with further reductions possible as a result of the Uruguay Round of multilateral trade negotiations — tariffs may well become less significant than wage and productivity differences in determining changing patterns of activity. In other words, the location decision to produce in Mexico is likely to be more sensitive to differences in wages and productivity between Mexico and its northern neighbors than to further changes in tariffs. In particular, a major question would seem to be the speed with which Mexican labor productivity can be improved, particularly by upgrading Mexico's educational and industrial infrastructure. If Mexico can improve its productivity, it should be in a very strong position to compete either under the present regime or in a free trade agreement. Moreover, with productivity improvements, Mexican wages will accordingly rise. With Mexicans facing a smaller productivity disadvantage, their concern about free trade with Canada and the United States should be alleviated. And with Canadian and U.S. producers facing a smaller wage disadvantage, their concern about a free trade agreement with Mexico should be reduced.

Finally, if Mexico wants to liberalize its auto trade, it should do so now. As the pressure from worldwide overcapacity increases, it may become more difficult to negotiate any kind of trade liberalization in this industry.

Some Implications for Canada

It has been observed that Canada must participate in any U.S.-Mexican free trade negotiation, whether it be in autos or more broadly across all sectors, in order to protect its interests — in particular, to protect hard-won gains acquired in past bilateral free trade agreements with the United States. While I support this position, it is important to understand that some gains can be protected, while others cannot.

A gain Canadians cannot protect is the preferential access to the U.S. market in competition with Mexico that we acquired in the 1965 auto pact and, more broadly, in the 1989 Canada-U.S. FTA. This preference would disappear as a result of either a Mexico-U.S. bilateral free trade agreement or a Canada-Mexico-U.S. free trade agreement. As noted above, the combination of U.S. tariff items 806 and 807, GSP, and Maquiladora in-bond privileges already give Mexico favorable treatment in its trade with the United States. A free trade agreement with the United States whether or not it includes Canada, would give Mexico even better treatment — indeed, the same free trade treatment Canada gets. Thus, Canada cannot retain its present preference over Mexico in the U.S. market, whether or not it participates in the Mexico-U.S. negotiations.

There are, however, gains acquired in the past that Canada can protect by participating in the negotiations. One such gain has been Canada's increased ability to compete against U.S. producers in the U.S. market, made possible by the elimination of U.S. tariffs. This competitive position would be eroded if Canada were to stand aside and allow Mexico and the United States to negotiate bilateral free trade, since U.S. producers would thereby be able to acquire duty-free inputs from Mexico that would not be available to producers in Canada. For example, bilateral Mexican-U.S. free trade in automotive equipment would allow auto production in the United States — but not in Canada — to benefit from low-cost, duty-free imports of auto parts from Mexico.

Another reason why Canada should participate in the negotiations is to ensure that the Maquiladora program is appropriately dealt with. At present, this provides producers in Mexico with duty-free relief on their imports from all countries. On imports from the United States, that duty-free privilege will be built into any Mexico-U.S. free trade agreement. It is the duty-free treatment of Maquiladora imports from Japan and other third countries that must be dealt with, just as duty drawbacks were dealt with in the Canada-U.S. FTA. If this is not done, then the duty-free treatment of Maquiladora imports from third countries would provide producers in Mexico with a competitive advantage over producers in Canada and the United States, and would lead to a costly distortion in trade and investment.

Notes

1 For more on these predictions and on the provisions of the auto pact described below, see Paul Wonnacott, *U.S. and Canadian Auto Policies in a Changing World Environment* (Toronto and Washington, D.C.: Canadian-American Committee, 1987); and idem., "The Automotive Sector in the Canadian-U.S. Free Trade Agreement," in Murray Smith and Frank Stone, *Assessing the Canada-U.S. Free Trade Agreement* (Ottawa: Institute for Research on Public Policy, 1987).

2 Because this agreement is too complex to describe completely, this *Commentary* concentrates on those provisions that are most likely to be relevant to possible free trade negotiations with Mexico.

3 Thus, Canada did not provide preferential treatment to the United States. Accordingly, Canada did not violate the most-favored-nation principle and did not have to obtain a waiver under the General Agreement on Tariffs and Trade.

4 These safeguards also increased the negotiating power of the Canadian autoworkers' union, since the government was essentially guaranteeing employment in Canada in this industry. This was an important issue for the Canadian economy as a whole because of the leading role of auto wages in the determination of wages in other industries.

5 For more detail, see Wonnacott, "U.S. and Canadian Auto Policies in a Changing World Environment," pp. 24–25.

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